

**Internal Revenue Service**

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Department of the Treasury  
Washington, DC 20224

Third Party Communication: None  
Date of Communication: Not Applicable

Person To Contact:

Telephone Number:

Refer Reply To:  
CC:TEGE:EB:EC  
PLR-104774-06

Date:  
August 07, 2006

Legend

X =  
Company =  
Date 1 =  
Date 2 =  
Date 3 =  
Year =

Dear :

This letter responds to your request for a private letter ruling regarding the treatment of nonstatutory stock options X transferred to you pursuant to a property settlement agreement incident to divorce. The facts represented in your request follow.

Your marriage to X was judicially dissolved on Date 1. Prior to the divorce, you and X lived in a community property state, and X was employed by Company. You and X executed a property settlement agreement on Date 2 to facilitate an equitable division of property incident to the divorce. Among other things, the property settlement agreement provided for your receipt of a portion of certain vested nonstatutory stock options (options) that Company granted to X in connection with X's performance of services. You represent that the options did not have a readily ascertainable fair market value on the date they were granted to X.

The property settlement agreement provides that X must retain physical possession of the options subsequent to the divorce, but that X must promptly comply with your written instructions to exercise the options. Consistent with your request, X exercised the options on Date 3. The underlying stock was sold immediately and the proceeds therefrom, less federal income and employment taxes, were forwarded to you. Company reported the option transactions on the Form W-2 it issued to X for Year. You have not yet filed your federal income tax return for Year.

Your request asks for rulings that the income attributable to the exercise of the options is includible in your gross income, even though it was reported on the Form W-2 Company filed on behalf of X; that you are entitled to a credit for the federal income tax Company withheld as a result of the exercise of the options; and that you are not entitled to a credit for the Federal Insurance Contributions Act (FICA) tax payments attributable to the exercise of the options.

Section 83(a) of the Internal Revenue Code (Code) provides, in general, that if property is transferred to any person in connection with the performance of services, the excess of the fair market value of the property over the amount, if any, paid for the property is included in the gross income of the person performing the services in the first taxable year in which the rights of the person having the beneficial interest in such property are transferable or are not subject to a substantial risk of forfeiture, whichever is applicable.

Section 83(e) of the Code provides that section 83 does not apply to the transfer of an option without a readily ascertainable fair market value.

Section 1.83-7(a) of the Income Tax Regulations (regulations) provides rules for nonstatutory options. Under those rules, if the option does not have a readily ascertainable fair market value on the date of grant, then sections 83(a) and (b) apply at the time the option is exercised or otherwise disposed of, even though its fair market value may have become readily ascertainable before that time. If the option is exercised, sections 83(a) and (b) apply to the transfer of property pursuant to the exercise, and the employee realizes compensation on the transfer at the time and in the amount determined under sections 83(a) or (b).

Section 1041 of the Code provides, in part, that no gain or loss shall be recognized on a transfer of property from an individual to a former spouse, but only if the transfer is incident to the divorce. Incident to divorce is defined in section 1041(c) as a transfer of property within one year after the date on which the marriage ceases or a transfer of property that is related to the cessation of the marriage.

Sections 3101 and 3111 of the Code impose FICA taxes on "wages" as that term is defined in section 3121(a). FICA taxes consist of the Old-Age, Survivors and Disability Insurance tax (social security tax) and the Hospital Insurance tax (Medicare tax). These taxes are imposed on both the employer and the employee. Sections 3101(a) and 3101(b) impose the employee portions of the social security tax and the Medicare tax, respectively. Sections 3111(a) and (b) impose the employer portions of the social security tax and the Medicare tax, respectively.

The term "wages" is defined in section 3121(a) of the Code for FICA purposes as all remuneration for employment, including the cash value of all remuneration paid in any medium other than cash, with certain specific exceptions. Section 3121(b) defines

“employment” as any service, of whatever nature, performed by an employee for the person employing him, with certain specific exceptions.

Section 3102(a) of the Code provides that the employee portion of FICA taxes must be collected by the employer of the taxpayer by deducting the amount of the tax from wages as and when paid. Section 31.3102(a)-1(a) of the regulations provides that the employer is required to collect the tax, notwithstanding that wages are paid in something other than money.

Section 3402(a) of the Code, relating to income tax withholding, generally requires every employer making a payment of wages to deduct and withhold upon such wages a tax determined in accordance with prescribed tables or computational procedures. Section 31.3402(a)-1(b) of the regulations provides that the employer is required to collect income tax withholding by deducting and withholding the amount thereof from the employee’s wages as and when paid, either actually or constructively.

Section 3401(a) of the Code provides that “wages” for income tax withholding purposes means all remuneration for services performed by an employee for his employer, including the cash value of all remuneration paid in any medium other than cash, with certain specific exceptions. Under section 31.3402(a)-1(c) of the regulations, an employer is required to deduct and withhold income tax notwithstanding that the wages are paid in something other than money and to pay over the tax in money.

Sections 31.3121(a)-1(e), 31.3306(b)-1(e), and 31.3401(a)-1(a)(4) of the regulations generally provide that the medium in which the remuneration is paid is immaterial. It may be paid in cash or other than in cash. Remuneration paid in any medium other than cash is computed on the basis of the fair market value of such items at the time of payment. Sections 31.3121(a)-1(i), 31.3306(b)-1(i), and 31.3401(a)-1(a)(5) provide that, unless specifically excepted, remuneration for employment constitutes wages even though at the time paid the relationship of employer and employee no longer exists between the person in whose employ the services were performed and the individual who performed the services.

Section 31 of the Code provides that the amount withheld from wages as income tax withholding will be allowed to the recipient of the income as a credit against the income taxes imposed by subtitle A. Section 1.31-1(a) of the regulations provides that the recipient of the income for purposes of the section 31 credit is the individual who is subject to income taxes upon the wages from which the tax was withheld.

In Rev. Rul. 2002-22, 2002-1 C.B. 849, individuals A and B were married and resided in a non-community property state. During the marriage, Corporation Y granted nonstatutory stock options to A. Pursuant to a property settlement incorporated into their divorce, A transferred one-third of the options to B. B exercised all of the options, and received Y stock with a fair market value in excess of the exercise price of the

options. The ruling concludes that the options are property within the meaning of section 1041, and it explains that section 1041 confers nonrecognition treatment on any gain that A may otherwise realize when A transfers the options to B. Under the ruling, A is not required to include in gross income any income resulting from B's exercise of the options. When B exercises the options, B must include in income an amount determined under section 83(a) as if B were the person who performed the services. The ruling further provides that the same conclusions would apply if A and B resided in a community property state and all or some of the options constituted community property that was divided between A and B as part of their divorce.

Rev. Rul. 2004-60, 2004-1 C.B. 1051, uses the same facts as the facts in Rev. Rul. 2002-22 and concludes, in part, that the options A transferred to B are subject to FICA and income tax withholding to the same extent as if the options were retained by A. That is, the ruling concludes that B's exercise of the options results in FICA wages for A to the extent that the fair market value of the stock received pursuant to the exercise of the options exceeds the exercise price. The ruling further holds that to the extent the exercise results in FICA wages, the employee FICA tax is deducted from the amounts paid to B, and the amount includible in B's gross income is not reduced by the FICA withholdings. In addition, Rev. Rul. 2004-60 holds that the income recognized by B with respect to the exercise of the options is remuneration for employment and wages for purposes of federal income tax withholding. Thus, because the income realized with respect to the exercise of the options is includible in the gross income of B, the ruling holds that B is entitled to the credit for the income tax withheld with respect to the exercise of the options.

Based on the foregoing, we rule as follows:

1. The income attributable to the exercise of the options is includible in your gross income for federal tax purposes;
2. You are entitled to a credit for income tax withheld from the proceeds derived from the exercise of the options;
3. You are not entitled to a credit for any FICA tax withheld from the proceeds derived from the exercise of the options.

A copy of this letter should be attached to any of your income tax returns to which it is relevant. You should also attach to such return a copy of the Form W-2, Wage and Tax Statement reporting the income tax withholding attributable to the exercise of the options, and statements reflecting the withholding with respect to the exercise of the options.

Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter.

This ruling is directed only to the taxpayer requesting it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

The rulings contained in this letter are based upon information and representations submitted by the taxpayer and accompanied by a properly executed penalty of perjury statement. While this office has not verified any of the material submitted in support of the request for rulings, it is subject to verification on examination.

Sincerely yours,

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KENNETH M. GRIFFIN  
Assistant Branch Chief  
Executive Compensation Branch  
Office of Division Counsel/Associate  
Chief Counsel (Tax Exempt and  
Government Entities)